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China's Relations with Mongolia: An Uneasy Road

Mark T. Fung



The lens through which China views its relationship with Mongolia spans the arc of history beginning with the end of the Song dynasty in 1271—the year that Khubilai Khan, the grandson of Genghis (Chinggis) Khan, invaded China to establish the Yuan dynasty—to the present. The Yuan dynasty survived until 1368, but this dynastic rule was plagued with natural disasters, as geologists stated, or lacked the Mandate of Heaven, as astrologers believed. The challenges of empire building by the Mongols were difficult, especially in a foreign land, made exponentially more so as a result of continuous drought, floods, earthquakes, locusts and epidemics. Most disconcerting was the outbreak of what forensic scientists and epidemiologists believe was bubonic plague: “It was the Mongols, after all, who infected the first Europeans—the Italians against whom they were laying siege on the north coast of the Black Sea—who transferred the disease back to Constantinople and Italy in 1347.”¹³⁷

The Mongol invasion was cataclysmic for China, not because it was the first time China was under foreign occupation by “barbaric” nomads, but because the Mongol invasion fundamentally changed how China administered itself. Remnants of Mongol rule remain to this day in China. Emphasis on the arts and civility gave way to brutishness and incivility. What was once the capital of the Southern Song dynasty, Hangzhou, located in southern China, and the most populous, wealthy, and cosmopolitan city in the world at the time, according to historian Jacques Gernet, was no longer the heart of Imperial China. “Thirteenth century China is

* I would like to thank Wonhee Lee at the U.S.-Korea Institute at SAIS for his research assistance.

¹³⁷ Timothy Brook, *The Troubled Empire: China in the Yuan and Ming Dynasties* (Cambridge, Massachusetts: Harvard University Press, 2010), p. 65.

striking for its modernism: for its exclusively monetary economy, its paper money, its negotiable instruments, its highly developed enterprises in tea and in salt, for the importance of its foreign trade (in silks and porcelains) and the specialization of its regional products.”¹³⁸ It was an era that situated China as the most modern, advanced economy, where the wealth effects of trading were transformed into appreciation of the arts and the amenities of life. However, in the end, the Mongol invasion altered the DNA of China forever.

The Mongols first abolished the time-honored Chinese tradition of impartial national exams as a recruitment tool for bureaucratic posts. Instead, the Mongols opted in favor of recommendations to Khubilai Khan by friends of the court. This, as Frederick Mote characterized, meant the establishment of nepotism on a wide scale in Chinese officialdom. The governance of empire by nepotism created a class of uneducated and unqualified officials who generated inconsistent or sporadic rulings.

These factors then spawned further degradation to the system of governance in China. Even when national exams were reinstated in China under the Ming dynasty, officials, who were, of course, coming of age during the Yuan dynasty, were inexorably affected by the detrimental changes under Mongol rule. In the end, Khubilai Khan’s conquest was forged through brute force and his kin ruled as such. In fact, these empires are never exceptional nor last very long. In contrast, Peggy Noonan said it best when she described how America was created: “It is a nation formed not by brute, grunting tribes come together over the fire to consolidate

¹³⁸ Jacques Gernet, *Daily Life in China: On the Eve of the Mongol Invasion 1250-1276* (Redwood City, California: Stanford University Press, 1962), p. 17.

their power and expand their land base, but by people who came from many places.”¹³⁹

China and Mongolia Today

What are we to make of China’s relations with the Mongolia today? In over seven centuries since the creation of the Yuan dynasty edifice, the fundamental character of the experience between China and the Mongols has remained relatively unchanged. It is still a relationship that is punctuated with and oscillates between distrust, cooperation, commerce, and insecurity.

Mongolia’s own insecurities and fear of Sinicization have led to its own self-manufactured mini-financial crisis in 2013. After the passage of a foreign investment law intended to prevent Chinese and Russian state-owned companies from owning majority shares in any natural resource companies, Mongolia’s regulations were still not clear, so they were interpreted by investors to mean all foreign investors were not welcome in the natural resource space. This caused a precipitous drop in the value of Mongolia’s sole asset: natural resources. This, in turn, led to a drastic depreciation of the Mongolian currency. The Tugrik dropped by as much as 60 percent against the US dollar settled back to only 20 percent depreciation on the black market, and officially depreciated by 3.7 percent in 2013.¹⁴⁰

¹³⁹ Peggy Noonan, “Putin Takes Exception,” *The Wall Street Journal*, September 13, 2013, <<http://online.wsj.com/news/articles/SB10001424127887323392204579071590253066918>>.

¹⁴⁰ “RPT-Fitch: Mongolia Election Makes Space for Greater Policy Clarity,” *Reuters*,

Investors were rightly frightened, and the delay of Rio Tinto's Oyu Tolgoi development plan¹⁴¹ was an indication that Mongolia's political leaders were not reliable and, more importantly, not amenable to economic growth. As Julian Dirkes argued in a compelling op-ed in the *Wall Street Journal*, "A sudden sense of economic crisis is spoiling the mood over Mongolia's three years of world-beating economic growth."¹⁴² He succinctly stated the malaise in Mongolia's leadership and its policies, "Putting aside Rio Tinto's ongoing construction in Oyu Tolgoi, foreign investment has fallen precipitously following the passage of a foreign investment law in May 2012. That law may have been designed to keep out state-owned Chinese companies, but other investors saw it as so vague and comprehensive that they left in droves."¹⁴³ Dirkes' argument strongly suggests that the hasty decision made by Mongolian officials would have detrimental financial and political effects on this small country with a population of approximately two million people.

China, on the other hand, perceives Mongolia to be a commercial partner and a geostrategic foothold. More specifically, Mongolia is a fount of natural resources at its doorstep to support

July 2, 2013, <<http://www.reuters.com/article/2013/07/02/fitch-mongolia-election-makes-space-for-idUSFit66239720130702>>.

¹⁴¹ Oyu Tolgoi is a copper and gold mining complex, situated in the southern Gobi desert of Mongolia, approximately 80 kilometers north of the Mongolia-China border and 550 kilometers south of the capital, Ulaanbaatar. The Government of Mongolia owns a 34 percent stake in the mine while Turquoise Hill Resources the remaining 66 percent, of which Rio Tinto owns 51 percent. Rio Tinto, since 2010, has been the manager of the project. For more details about the Oyu Tolgoi development project, refer to the website of Rio Tinto at <<http://www.riotinto.com/ourbusiness/oyu-tolgoi-4025.aspx>>.

¹⁴² Julian Dirkes, "Mongolia's Choice on Investment," *The Wall Street Journal*, September 12, 2013, <<http://online.wsj.com/article/SB10001424127887323595004579070600648039692.html>>.

¹⁴³ *Ibid.*

China's economic growth as well as becoming a potential junior partner in counterbalancing the influence of Russia, its imposing neighbor to the North. In the past, China discouraged Mongolia from selling its coking coal to any third country. One method to discourage this trade was to limit the railcars to certain destinations within China.

The primary person responsible for this policy was the Minister of Railway of China, Liu Zhijun, who has since been convicted of corruption and sentenced to death in 2013 with a two-year reprieve. To be sure Liu was never particularly accommodating to the entreaties of the Mongolians and was the source of tension in China-Mongolia relations. He made his views known privately and sometimes publicly. In one meeting held in Beijing, observers who were present said, Liu came out to greet his Mongolian counterparts, in a white t-shirt, which can be construed to mean his disrespect towards the Mongolians.

Since Liu's suspended death sentence, China's railway ministry has gradually been dissolved. As a result, its administrative functions were moved to the Ministry of Transport and its commercial role to the China Railway Corporation in March 2013.¹⁴⁴ Liu, the son of peasants from Hubei province, rose to his rank slowly and gradually, beginning in the 1970s as a low-level office worker. Liu took advantage of the political system at a time when corruption was relatively unchecked in China. Analysts believed that the railway ministry in China was particularly susceptible to corrup-

¹⁴⁴ Clifford Coonan, "China's former Railways Minister Liu Zhijun receives suspended death sentence for bribery and corruption," *The Independent*, July 08, 2013, <<http://www.independent.co.uk/news/world/asia/chinas-former-railways-minister-liu-zhijun-receives-suspended-death-sentence-for-bribery-and-corruption-8694906.html>>.

tion due to the amount of government funding it enjoyed. Things have changed under President Xi Jinping and the new tone of this leadership has been to purge the political system of corrupt impurities. Eliminating the railway ministry in China could serve as a new opportunity for China and Mongolia to link together both politically and physically by railway.

Understanding Mongolia

Mongolia was fundamentally affected by Soviet domination of Mongolia just as China was tainted by the rule of the Mongols. The Cyrillic alphabet that was superimposed by the Soviet Union on the beautiful cursive of traditional Mongolian language in the 1940s exists to this day. The adoption of the Cyrillic alphabet was decreed in March 1941, justified on political grounds, following its general application to minority languages in the Soviet Union.¹⁴⁵ Russian political motives to keep it as a buffer state to China remain operative.

Mongolia is a predominantly nomadic and agrarian society that is attempting to undergo the metamorphosis of modernity. However, without physical links to the outside world, and critically landlocked between China and Russia, Mongolia's growth will continue to be stunted as will its relations to the outside world. The past inclination and popular belief of the Mongolian people is that Russia is not an existential threat and is an ally.

¹⁴⁵ Alan J. K. Sanders, *Historical Dictionary of Mongolia* (Lanham, Maryland: Scarecrow Press, 2010), p. 638.

Yet, there is a growing sentiment in Mongolia, particularly among the elite educated abroad but not in Russia, that perhaps Russia is not acting in the best interests of Mongolia. One prime example is Russia's long-standing refusal to renegotiate its fifty-fifty equity partnership in the existing joint Mongolia-Russian railway.¹⁴⁶ Russia has failed to invest or upgrade the railway network for nearly half a century and holds effective veto over any infrastructure improvements that Mongolians want to perform on the current Mongolian-Russian railway system.

Three Key Events

Three specific and recent events are emblematic of China's relations towards Mongolia: (1) passage of Mongolia's National Railway Policy in 2010 and its case study; (2) Aluminum Corporation of China's (Chalco) \$250 million coking coal supply agreement with Mongolia's Prime Minister Batbold in July 2011 which Mongolia sought to renegotiate six months later in January 2013; and (3) the foreign investment law passed by Mongolia's parliament in May 2012 that effectively targeted Chinese state-owned enterprises from holding a majority equity ownership in natural resource companies of Mongolia. The language of the law

¹⁴⁶ As a result of the agreement signed by Joseph Stalin and Khorloogiin Choibalsan in 1949, the Ulaanbaatar Railway Company (UBTZ) is 50 percent owned by Russian Railways (RZD) and 50 percent by the Mongolian government. While the two governments recently trying to renegotiate the terms of this agreement, they have failed to make a rapid progress. See "Transport and Logistics Analysis," *The Report: Mongolia 2012* (London: Oxford Business Group, 2012), p. 135.

was so vague and imprecise, however, that it could apply to any foreign investor.

Ultimately, these cases are intertwined and depict the challenge in decision-making processes among Mongolian officials, often vacillating between two antipodal decision points. The failure is not their fault entirely. Rather, it is the lack of established institutions for governance. Ironically, this can be traced back to the very institutions that the Mongols obliterated under the Southern Song dynasty to make way for the Yuan dynasty. In short, it is a custom and practice, honed over time in the nomadic life on the steppes of Mongolia that perpetuates the falsehood that commitments and decisions, like the wind, can blow in any direction without consequences.

The shortfalls of institution-building and good governance in Mongolia are also perhaps a reflection of the intellectual starvation that Mongolia suffered during the years of Soviet, and now Russian, influence. All institutions of higher learning in Mongolia are sub-standard by objective global metrics for academic quality. This was probably deliberate, as Stalin and his successors chose the path that would lead to the least resistance by Mongolia's elite.¹⁴⁷ Today, fortunately, some Mongolians have ventured far and wide to study overseas, including South Korea, the United States, the United Kingdom, Europe, China, and Australia, among other locations.¹⁴⁸ They are gradually becoming cosmopolitan and, most

¹⁴⁷ Mongolia had a Soviet-style educational system with "highly specialized curricula designed to prepare students for jobs in a command economy." See John C. Weidman and Brian Yoder, "Policy and Practice in Education Reform in Mongolia and Uzbekistan during the First Two Decades of the Post-Soviet Era," *Excellence in Higher Education* (2010), p. 57, <<http://d-scholarship.pitt.edu/17627/1/16-14-2-PB.pdf>>.

importantly, have access to ideas.

Act One: Case Study of Mongolia’s National Railway Policy

This case study examines the attempt to physically link Mongolia to the outside world via China by rail, increasing Mongolia’s supply of “black gold”—coking coal—to markets in China, South Korea, and Japan.

On June 28, 2010, the Mongolian government promulgated its National Railway Policy, which set forth both a southern and eastern railway to be constructed simultaneously and named the Mongolia State Railway Company (MTZ) as the legally authorized representative for Mongolia.¹⁴⁹ The national policy also called for the railway to be linked directly to a port and permit port access. In order for Mongolia to emerge from its isolation, deep-water port access is critical.

The primary reason for this new policy was that many companies desired to build only the southern line connected to China as it was clearly the most profitable and shortest route. This southern railway line also required the least capital investment and was

¹⁴⁸ According to the figures released by University Fair in 2010, approximately 9,167 Mongolian students are studying abroad. South Korea accounts for 600, the U.S. 820, the U.K. 98, Germany 1,200, People’s Republic of China 230, and Australia 38. For more details, refer to the University Fair website at <<http://universityfairs.com/fairs/international-education-exhibition-mongolia-44>>.

¹⁴⁹ “Mongolian Railway” State Owned Shareholding Company (MTZ) was established on March 20, 2008, based on the 82nd resolution of the Mongolian Government and 189th decree of the State Property Committee. For more information about the company, refer to the website of Mongolian Railway at <<http://www.mtz.mn/index.php?sel=about&more=6>>.

the easiest to implement. Hence, it was attractive to many Mongolian political and business leaders. This was a parochial, but practical means of exporting Mongolia's natural resources. However, doing this had one consequence: there would only be one buyer and the price advantage disappears when there is only one buyer.

The 2010 National Railway Policy of Mongolia sought to correct this geopolitical trajectory gone astray. Passing the parliamentary resolution, Mongolia designated its new national railway company, MTZ, as the lead agency to implement this new national railway policy. It mandated that two railway lines, instead of one, be built.

The first railway line called "Phase One" would lead from the Tavan Tolgoi (TT) coking coal reserves in south central Mongolia, which is one of the largest in the world, with an estimated 6.4 billion metric tons of reserves to Zamin Uud, a southern Mongolia frontier town. The reserves at TT are large enough to meet coal needs of Japan for the next forty years. At the same time, the policy called for a "phase two" to be built concurrently, also originating from TT but with a railway that headed eastbound to China through a port located in the uppermost reaches of Bohai Bay in Liaoning, China, herein named X. This is the largest private port in China with an annual throughput of 100 million tons.¹⁵⁰ This port was more than sufficient to accommodate the expected annual shipments of sixty to eight million metric tons of coking coal from

¹⁵⁰ For detailed information about Phase One and Phase Two, see Ministry of Road, Transportation, Construction and Urban Development of Mongolia, "New Infrastructure Development Projects Snapshot," <<http://www.coneq.org.uk/Mongolia/New%20Infrastructure%20Development%20Projects%20in%20Mongolia.pdf>>.

Mongolia once the TT mines were operational.

In fact, this eastbound railway route has a particularly beneficial feature: a five-square kilometer special zone designated for the Mongolian use, expected to benefit Mongolia's coking coal producers and sellers. They could defer sales when prices were low and store coking coal and other commodities at this facility. This would enable the mines to operate continuously and not be idle, thus guaranteeing that Mongolian mining jobs would be uninterrupted during price fluctuations. The normal practice in mine operations is to shut down operations once the market price reaches below a certain pre-determined level. Finally, the total distance for the two combined railway lines totaled 1,800 kilometers; the railways would serve as Mongolia's main arteries, both commercial and geostrategic. It was a grand vision, if it could be properly implemented.

On July 11, 2010, a former senior White House official, also known as one of the world's greatest grand strategists for Asia and Central Asia, traveled to Mongolia at the invitation of Prime Minister Batbold to celebrate Mongolia's annual Naadam festival. During the visit, a discussion of this railway was raised and explored. At the time, Prime Minister Batbold, along with his deputy transportation minister, Gansukh, was present at the discussion to determine whether this railway would even be feasible.

By October 2010, a former senior State Department official met with the Mongolian prime minister's top infrastructure advisor, Enkhbayar, at the Grand Hyatt Hotel in Beijing to gauge the seriousness of the Mongolians in this endeavor and to gain support from the former high-ranking State Department official for the eastbound railway linking Mongolia to X port. In both the meetings the Mongolian government had with two former high-ranking

U.S. officials, respectively, it was abundantly clear that the geo-strategic benefits of weaning the Mongolians away from the Russian sphere of influence within Mongolia would be advantageous not only to Mongolia itself, but also to the United States as well as China.

This, in turn, would benefit South Korea, since it is fully cognizant of the importance of a strong relationship between the United States and China. South Korea, being connected to the U.S. for security reasons and to China for economic reasons, would gain from a strong U.S.-China relationship. This Mongolia railway project would seem to serve that goal. Indeed, it was a zero-sum game: any reduction in Russian influence over Mongolia would create positive externalities for Mongolia, China, South Korea, and the United States.

The following month, November 2010, a senior executive from X along with its chief representative in Mongolia met with Vice Minister of Transportation Gansukh, in 2013 the minister of transportation, to present X's proposal of building the railway and its positive linkage to a port city, which includes a five-square-kilometer zone for the exclusive use of Mongolia. In this way, Mongolia's exporters could sell natural resources when the prices are attractive and warehouse coal, for example, when prices are depressed. Vice Minister Gansukh suggested that the proposal be submitted directly to the Minister of Transportation, Battulga.

Battulga was an important political power player in the Mongolian Democratic Party (DP) but was viewed as a political loner. He possessed a sense of confidence, having helped oversee Mongolia's five-medal win in the 2012 Olympics in Beijing.¹⁵¹ He was a popular figure who focused on the activities to appeal to his constituents such as building a supermarket in an otherwise un-

forgiving, desolate area of Mongolia's southwest, a cold, barren wasteland. This enabled Battulga to rise to political fame with very little capital. He would be continuously re-elected as long as the supermarket was open and goods could be purchased in an otherwise nondescript city that was his hometown. In Mongolian politics, to serve in the cabinet, the only requirement was that one must already be an existing parliament member.

Battulga is a politician whose career is highlighted by street savvy and business acumen rather than public speaking skills and educational experience. In the 1990s, when Mongolia earned its independence along with the other Soviet satellites, he saw an opportunity to import basic electronics from Singapore to Mongolia. As he accumulated some wealth from the Singapore electronics trade, he expanded to other business ventures in Mongolia, such as tourism, hotel, bread manufacturing, and beef processing, to name a few, all generating the requisite cash in a cash-based society to fulfill his growing political ambitions.

The income generated from these businesses would help launch his political career and those of his allies such as President Elbegdorj during his first run for the presidency. This ministerial post was Battulga's first one as a cabinet official after being elected to the Parliament.

Battulga preferred to work from his business office, which was located in the local hotel that he owned, rather than the office of his ministry. He found it was safer both physically and psychologically, as his CCTV monitors would record the movement of

¹⁵¹ Mongolia won two silver and three bronze medals and was the most successful Mongolian participation in Olympics history. One bronze and one silver went to Mongolia for judo, a sport very close to the heart of Battulga, a judo champion himself.

people entering and leaving his building. He was physically fit and if a guest came unannounced he could catch him practicing judo in his office. Battulga would greet visitors to his office with a customary show of camaraderie by extending an offer for vodka shot before anything was discussed. It was his way of breaking the ice with Mongolians and foreigners alike.

Along the wall of his office, there was a dry-erase whiteboard with many hand-drawn lines extending over the basic contours of a map of Mongolia and its railway network. Battulga also had a vision of creating an industrial park in Sainshand, a city in the middle of Mongolia and just north of the coking coal mines of Tavan Tolgoi. Sainshand, it was envisioned, would serve as the virtual command center for industry and meet the power needs for the mining operations nearby. Its designs also included a coal gasification plant to generate electricity as well as an oil refinery and coking coal washing facility to increase the value-added of Mongolia's exports. It was thoughtful, but required capital and more importantly, the management and international experience that Mongolia simply lacked. It would have to rely on outside expertise. In June 2013, Bechtel, the large U.S. engineering firm was found to manage the development of this industrial complex.

Battulga was aligned with the Russian camp of supporters in Mongolia. Having a Russian girlfriend and being fluent in Russian himself, he was comfortable with the Byzantine demands of Russian politics and its sway over Mongolian politics and seemed to navigate it well. When it was expedient, he would conjure up the Russian political connection and demonstrate that he was one of the "privileged" few whom the Russians sought to exert influence over. Battulga's inclination towards the Russian camp meant that his ability to navigate Chinese politics would be compromised.

Chinese officials would be less likely to trust Battulga, given that the two main outside stakeholders for Mongolia are Russia and China. A proximity to the Russian sphere naturally meant a distance from the Chinese sphere in Mongolia.

At other times, Battulga realized that being under the Russian sphere of influence did not serve his country's long-term goals of becoming self-sufficient and truly independent. In a May 2013 article in the *Asia Times*, Mongolians claimed that the oil supply from Russia had been interrupted on political grounds and that these products failed to meet consumer and industrial demand due to their increasingly high prices.¹⁵² The figures commonly being touted are that about 90 percent of Mongolia's petroleum products are imported from Russia¹⁵³ while some 70 percent of all food requirements of Mongolia were supplied by China.¹⁵⁴ Because existing infrastructure was required to transport all the fuel and energy, Mongolia is currently dependent on Russia for its energy needs. The industrial park in Sainshand, the construction of the railway leading to China with port access, and increased shipments of coking coal would hopefully wean Mongolia off its energy dependence upon Russia.¹⁵⁵

¹⁵² Alicia J Campi, "Sino-Mongolian oil deal undercuts Russian role," *Asia Times*, May 15, 2013, <http://wwwatimes.com/etimes/China_Business/CBIZ-01-150513.html>.

¹⁵³ See, for example, "Mongolian Dependence a Threat," *The Moscow Times*, June 24, 2011, <<http://www.themoscowtimes.com/business/article/mongolian-dependence-a-threat/439408.html>>.

¹⁵⁴ With regard to how much food Mongolia imports from China, World Vision, a Christian relief, development and advocacy organization, reveals, "Some 70 percent of Mongolia's food is imported from China." To access to the full document on Mongolia's food security, refer to World Vision, "Mongolia Facing Food Challenges," <http://www.worldvision-institut.de/_downloads/allgemein/Food%20security%20in%20Mongolia.pdf>. However, some experts estimate that China accounts for about 90 percent of Mongolia's food imports.

At any point in time, if there was any perceived political offense towards Russia by Mongolia, Russia would cause a temporary shutdown of energy supplies resulting in a spike in gasoline costs and long lines at the gasoline station. It is widely known that Russia has used its energy supply to Mongolia as political and economic leverage.¹⁵⁶ Yet strangely, the Mongolian people would direct their anger not at the Russians, but at the mining or energy minister or even the prime minister. Any official with a hand in relations with Russia would be blamed for not maintaining good relations with Russia. It was a counterintuitive way to assess the situation. In the end, this was a game of political survival, or perhaps self-preservation, for Battulga.

Power and electricity were in great demand and often power outages even in the capital of Ulan Baator seemed to be a constant reminder that Mongolia was not ready for prime time.¹⁵⁷ These were not just growing pains of a developing country. Mongolia was

¹⁵⁵ Having an interview with *China Daily* in September 2010, Minister Battulga revealed his hope that Mongolia's industrial sector would reach China's markets more easily, saying, "We are planning to have as much value-added processing done inside of Mongolia, at a new industrial park based in Sainshand, a town that already has urban infrastructure and is close to China." See "Railway plan will transport Mongolia into a 21st C economy," *China Daily*, September 13, 2010, <http://www.chinadaily.com.cn/cndy/2010-09/13/content_11291572.htm>.

¹⁵⁶ According to *Reuters*, Russia has been known to shut down gas supply taps amid a price dispute with Ukraine. Moreover, after Russia cut oil and diesel exports to Mongolia in April 2011, Mongolia's mining activity was severely hampered due to sharply increased pump prices and bus fares. To access the full article, refer to "RPT-Mongolia's energy reliance on Russia, China a key risk," *Reuters*, June 21, 2011, <<http://www.reuters.com/article/2011/06/22/mongolia-fuel-idUKL3E7HM03J20110622>>.

¹⁵⁷ In October 2012, the Ministry of Energy of Mongolia warned citizens of Ulan Baator an impending electricity shortage, which may require suspension of power supply in December. See, for example, M. Zoljargal, "Ulaanbaatar in Danger of Energy Shortage," *The UB Post*, October 19, 2012, <<http://ubpost.mongolnews.mn/?p=1567>>.

a “frontier” country that was far riskier to invest in than the already financially risky emerging markets.

There are no five-star hotels in Ulan Baator in 2013. Executives from state-owned firms in China as well as from South Korea and Japan frequently fill the hotels in Ulan Baator. The roads are completely dilapidated and congested. Two lanes each way serve as the main thoroughfare from the city center to the airport. Along the way, large bumps, potholes, and uneven surfaces on recently paved roads seem to serve as a parable of what it would be like for investors doing business in Mongolia. Officials are allowed to engage in outside business activities in addition to being salaried officials within government. Accordingly, it can be assumed that at times the lines between these two spheres may become blurred.

Vice Minister Gansukh was an eloquent man in his late forties with large swaths of white hair. A lawyer by training, he spoke English fluently, but did not project confidence as an official. Like Battulga, he was affiliated with the DP in Mongolia, but maintained close ties to the Mongolian People’s Party (MPP), the legacy of the Soviet Union and the Communist era. However, unlike Battulga, Gansukh did not possess any political base of his own. He was dependent upon the good graces of his political patrons, such as Battulga and others in the DP. Among the close ties he maintained, Gansukh had familial ties to the prime minister of the MPP, Batbold. Therein explains the reason Gansukh was the only member of the DP that was invited to festivities organized by Prime Minister Batbold during Naadam.¹⁵⁸

Batbold’s anointment as the prime minister would be an il-

¹⁵⁸ For more information about the Naadam festival, refer to the BBC website at http://www.bbc.co.uk/nature/humanplanetexplorer/events_and_festivals/naadam.

lustrative example of accidental leadership. He was not a confident speaker, but, like Gansukh, he was fluent in English. He was the compromise candidate for the prime minister position in 2009, when the previous prime minister Bayar sought “medical leave” right after signing the agreement involving Oyu Tolgoi, the largest copper and gold mine in Mongolia and probably the world.¹⁵⁹ Batbold was seen as the least common denominator. His official residence was strewn with photos with heads of state of many nations such as South Korea, Japan, Russia, and U.N. Secretary-General Ban Ki-moon. He did not have a picture with the president of the United States, only with Vice President Joe Biden.

Some Mongolian observers described Batbold’s tenure in office as prime minister as mediocre. Based upon his background, those who considered his administrative experience insufficient questioned whether he could serve as a successful leader even though he had served as foreign minister. He seemed to be biding his time in the office of prime minister hoping that history would be kind to him in the annals of Mongolian politics. These realities would not serve him well in his relations with Beijing despite his career as the chairman of the MPP, the legacy of the Communist Party. Batbold’s final official trip to Beijing occurred on June 15, 2011 and lasted three days according to Xinhua, the official news agency of China. During this time, he was unable to secure any deliverables except the hope of stronger China-Mongolia relations.¹⁶⁰

Having narrowly escaped no-confidence votes in the Parlia-

¹⁵⁹ “Mongolia PM resigns due to health,” *The China Post*, October 27, 2009. <<http://www.chinapost.com.tw/asia/other/2009/10/27/230268/Mongolia-PM.htm>>.

¹⁶⁰ “China, Mongolia pledge closer relations as Mongolian PM visits,” *Xinhua*, June 15, 2011, <http://news.xinhuanet.com/english2010/china/2011-06/15/c_13931822.htm>.

ment, or Great Hural, Batbold soon realized his political days were numbered and the prospect of winning in 2013 and retaining his prime minister post would be untenable. As a result, he began to accelerate his plans, some say, of rent-seeking. In exchange for approving government projects or obtaining valuable land, Batbold would award government-related projects to the highest bidder, adding to his personal coffers. People who knew Batbold well would describe him as a man who would turn his back on his own friends and colleagues. Batbold was also a loner, far less competent and perpetually unskilled in the halls of power than any of his predecessors.

Simply put, Batbold had no base of support. He relied upon the good graces of former Prime Minister Bayar, who stepped down after signing the Oyu Tolgoi agreement, left for South Korea for a medical treatment, and finally settled in an American middle-class suburb of Chicago, biding his time as questions arose about his alleged corruption. In a peculiar way, and one demonstrative of Mongolian politics, despite the corruption allegations against him, Bayar was still a popular figure in Mongolia, and this enabled Batbold to remain in power at least temporarily.

By December 2010, the seriousness of X's proposal to construct a railway leading to its port was gaining significant traction within the Mongolian government. So much so that a representative of X was invited to Mongolia for the first time, and executed a memorandum of understanding (MOU) with Minister Battulga on the railway and port. Subsequently, X's senior executives began meeting with Minister Battulga's chief representative on railway, Ganbat. The team for both sides met for virtually the entire month of December in the frigid temperatures of winter in Ulan Baator to negotiate the terms that were memorialized and committed to later

in a joint development agreement (JDA).

This agreement was drafted by a law firm retained by MTZ and was viewed in the light most favorable to the Mongolians. MTZ's lawyer was a Pakistani-American, who did not subscribe to general ethical principles. He felt most comfortable in the grayest of gray areas of ethics. As a lawyer, his reputation was not generally viewed upon favorably by any of the large law firms either in Washington, D.C., where he was a partner in a smaller firm, or in Ulan Baator. However, he was willing to travel to Mongolia, unlike other U.S. law partners, and spend time on the railway endeavor. He was a close personal friend of Ganbat and out of loyalty to this lawyer, Ganbat would make sure that any law firm retainers granted by MTZ would be directed towards the lawyer. It was admirable, but ultimately flawed, because both of them were too entrenched in the enterprise of self-enrichment, rather than the greater good of the project and country.

Mongolia by birth, Ganbat grew up in Moscow, the son of an academic living in Russia at the time. This made him unaccommodating to China and he failed to appreciate how Chinese politics would or could function. Fluent in Russian and English, his Mongolian was difficult to understand, we are told, but he managed to align himself with Battulga, who desperately needed advice from someone with international experience who also spoke Mongolian. Ganbat had virtually no ties in Mongolia since his roots were in Russia. Ganbat studied at a university in Delaware and graduate school in New York. He worked at a second-tier bank and realized that perhaps his prospects would be better in the growing economy of Mongolia.

The JDA, as ultimately agreed upon by all parties, called for a 67 percent equity share for X and its affiliates while MTZ held 33

percent. It also called for X to deposit \$1 million dollars in a Mongolian bank for initial development fees as the joint shareholder agreement would require further legal and accounting expenses.

By January 2011, the JDA was signed by all legal stakeholders: Batzaya, the MTZ (state railway) chairman, X's chairman, as well as by the Minister of Transportation Battulga, who witnessed the signing, and whose ministry has regulatory oversight over MTZ. In the end, the mutually agreed terms were that X would hold 67 percent and MTZ would hold 33 percent equity of the project company and hence the railway project.

Additionally, since there was a high degree of risk, both legal and political, in dealing with Mongolia, it was a standard practice to use and agree to an arbitration clause that utilized an international venue. New York was designated as the venue for dispute resolution. In the end, X satisfied each and every obligation that the Mongolian MTZ requested. As the agreement was signed and the next step was the shareholder's agreement, X assumed that Mongolia was a country that would respect laws of its own making and international norms. This, unfortunately, is not the case in Mongolia. The implementation phase of the contract was one that required the assistance of a meteorologist who could discern the direction of the winds. This was the fundamental business environment in Mongolia.

By June 2011, a former senior US State Department official visited Mongolia at the invitation of Prime Minister Batbold and reinforced X's position and stated in no uncertain terms that the rule of law and honoring contracts were an important component of international credibility, especially for this railway project, where a binding agreement was signed by the Government of Mongolia.

After this conversation was over, unfortunately, it turned out that Prime Minister Batbold took the passive-aggressive approach toward politics, which aroused criticism from his political opponents. He reassured the former American official that the process was moving forward, but behind the scenes, as we ultimately learned, he was in all likelihood practicing rent-seeking and bidding out the railway project to the highest bidder for his personal bank account. The United States, China, and South Korea, to varying degrees, all supported this railway project and X's participation in the project as a majority investor and main operator. Instead, rather than taking advantage of a unique opportunity to benefit Mongolia and serve its future, Batbold chose to use this project for his own personal and political gain.

One of the reasons often mentioned by Mongolians for the delay in the implementation of the agreement with X was that the Russians often would interrupt any progress with a demand that Russia, by its proxy, have a stake, often without paying for its stake. In other words, the Russians wanted a gratis share of the equity of this railway project. Of course, this was unacceptable for any business venture.

The Mongolian officials face a critical moment when their deliberate decision-making determines whether the current effort to develop the country socially, economically, and politically will end up with continued dependence upon Russia or bring it a new era of prosperity that port access and trading with third countries would offer. However, Mongolia's practices reveal that it has consistently tilted towards Russia after vacillating between Russia and China. This became the main obstacle to stronger China-Mongolia relations. Hence, Mongolia needs to situate itself in the overall geostrategic landscape of the world. Does it want to serve as a critical

linchpin in Central Asia or merely continue its legacy of being tied to an oil-revenue dependent Russia?

Another reason that was cited by Mongolians for the delay was the need to obtain stronger Chinese political support for this project. The parties to the agreement had to reach the implementation stage for there to be an action item on the agenda for China's political leaders. Chinese officials at all levels would not commit themselves to any project, whether undertaken in China or outside its borders, unless government funds were used. Here, this was a private company that negotiated an arm's-length contract with the Government of Mongolia.

However, what this project demonstrated was that the Mongolians, even though they conquered and occupied China nearly seven centuries ago and have had continued interactions as a neighbor, in general, fail to grasp Chinese political culture. The Mongolians would request X to arrange meetings with senior Chinese officials on short notice even though the Mongolians themselves sent mixed signals on how they intended to implement the signed agreement. X was not prepared to expend further political capital on an uncertain and capricious partner.

Honoring commitments and agreements is as old as time itself. Regardless of where one sat on the political spectrum in China, one truism remains: the Chinese government will honor agreements that its officials make with foreigners. The episode of Beijing mayor Chen Xitong is a perfect example. In the 1990s, Chen approved a large real estate development in Wangfujing, the heart of Beijing, which was proposed by a renowned Hong Kong developer.¹⁶¹ Later, it was discovered that Chen was not authorized to approve such a large swath of land so close to the corridors of power in Beijing. Chen was later imprisoned for alleged corruption

and recently passed away penniless. However, Beijing honored the land development project that Chen agreed to.

By September 2011, Minister Battulga and Mongolia's Ambassador to China visited X. They were impressed with the breadth and scope of the port operations, which spanned 60 square kilometers. X arranged for a police escort to accompany Minister Battulga throughout his trip as he met with local Chinese officials who reiterated the financial and operational capabilities of X. Minister Battulga stated that this trip was the "best reception he has ever had in China," according to Ganbat, his top aide.

At the same time, also in September 2011, executives from X and the former senior American official met with Mongolia's President Elbegdorj during the United Nations General Assembly annual meeting in New York. The message of implementing the duly signed JDA between X and Mongolia was further reinforced. The president also stated his support for X's participation in the railway project and counseled "patience" due to the nature of Mongolian politics.

It was, indeed, the president's way of saying that Mongolia had not reached the political maturity to effectuate and implement international agreements. Rio Tinto's experience in Mongolia exemplifies the difficulties the country faces while it attempts to tackle the challenges to its economic and political development. Its leaders have traditionally found it easier to maintain the status quo

¹⁶¹ In November 1994, the State Council ordered the suspension of this \$2 billion Hong Kong-financed project after it was revealed that the Beijing city government had proceeded with the project without getting proper permission from the central government. See, for example, "RPT-Mongolia's energy reliance on Russia, China a key risk," Reuters, June 21, 2011, <<http://www.reuters.com/article/2011/06/22/mongolia-fuel-idUKL3E7HM03J20110622>>.

in its relations with Russia than extending their reach and expanding cooperation with China. Thus, to some extent, their tilted attitude towards Russia suggests that its leaders preferred the era of the gers,¹⁶² or tents, to modern housing for its people. This political and economic climate would increasingly become untenable for China's state-owned firms.

The Mongolian practice of not honoring international commitments would bode ill for future investments in Mongolia.¹⁶³ For example, as Rio Tinto's Oyu Tolgoi operations were about to commence in 2012, the Government of Mongolia and especially President Elbegdorj requested a re-negotiation of the agreement.¹⁶⁴ Rather than submitting to this type of coercion by the Mongolian government, Rio Tinto simply closed its mining operations until a final settlement could be reached. Rio Tinto, the largest mining company in the world, stared down the Government of Mongolia and called its bluff.

In February 2012, the Mongolian ambassador to China paid a second visit to X. It was a sign that the Mongolians wanted to resume the implementation of the JDA. Sure enough, in April 2012, Mongolia requested that X's executives to travel to Ulan Baator on

¹⁶² A yurt (Mongolian: ger) refers to a portable, bent dwelling structure traditionally used by Mongolian nomads.

¹⁶³ According to Coface, a French company specializing in export credit insurance, Mongolia's rating both in Country Risk Assessment and Business Climate is C. Its analyses use a seven-level ranking. In ascending order of risk, these are: A1, A2, A3, A4, B, C and D. For detailed information about its risk assessment on Mongolia, refer to the website of Coface at <http://www.coface.com/Economic-Studies-and-Country-Risks/Mongolia>.

¹⁶⁴ Jesse Riseborough and Elisabeth Behrmann, "Rio Rejects Mongolia Request to Renegotiate Copper Mine Deal," *Bloomberg News*, October 15, 2012, <http://www.businessweek.com/news/2012-10-15/rio-rejects-mongolia-request-to-renegotiate-copper-mine-deal>.

short notice to attend a series of meetings in order to establish a method to cooperate with MCS, the large mining corporation that is listed on the Hong Kong stock exchange with a market capitalization at the time of approximately \$3 billion. It was MCS that had the largest vested interest in a southern railway line. MCS owned 3 percent of the TT coking coal reserves.

Prime Minister Batbold had financial interests with MCS, we are told, because it was he, as a private businessman, who orchestrated the accumulation and control of TT mines. It is staggering to think that \$100 billion of national assets could potentially be diverted to one individual. When the Mongolian public heard that Batbold had accumulated so much potential wealth at the expense of the Mongolian people, the public was outraged and politicians were incensed—perhaps not because of the alleged self-enrichment, but because they were not included.

Batbold quietly returned the TT mines back to the government while retaining up to 3 percent which would become the basis for holdings of MCS. X's executives and the chairman of MCS, Jambaljamts Odjargal, signed an MOU for joint cooperation on the construction of the southern railway line. This was supposed to remove any final obstacles from the Mongolian business community, as MCS was interested in building its own railway line to the Chinese market to the south, initially without any partners.

The political winds began to shift in Mongolia as the public became increasingly frustrated with the old system under the MPP, the legacy party from the days of the USSR. The MPP was rife with corruption, ineptness, and cronyism. Its inability to effectively deal with China and Russia was a clarion call for a new breed of politicians from the Democratic Party of Mongolia (DP).

In August 2012, Altankhuyag of the DP was elected prime

minister, ousting MPP's Batbold.¹⁶⁵ At the request of the Ministry of Transportation, X met with Minister of Transportation Gansukh who wanted assurances that X remained committed to the project despite the change in political leadership and to lay a framework for moving forward. These Mongolian officials, like the wind, would blow in one direction and then another.

Senior Chinese government officials are reluctant to face instability and unpredictability. In particular, China's political system and its society are not fully prepared to deal with instability and unpredictability. Moreover, throughout the centuries, the belief that instability caused weaknesses in China and thus encouraged foreign intervention was widely subscribed to in China. China's worry over *neiluanwaihuan* (内乱外患), which refers to the two-fold calamity of internal disturbance and foreign invasion, features prominently in China's strategic thinking.

Beijing has generally not directly dispatched senior government officials to Mongolia, with one exception.¹⁶⁶ On January 12, 2012, the Chinese government sent its head of public security, Politburo standing committee member Zhou Yongkang, to Ulan Baator for a groundbreaking ceremony for a housing complex that would serve thousands of Mongolians, financed courtesy of China's Export-Import Bank. Zhou would travel exclusively to Mongolia on this trip and then return to Beijing.

¹⁶⁵ The DP won the parliamentary election in June 2012; however, the appointment of Norovyn Altankhuyag came weeks after coalition talks following the election. For more information, see E. Dari, "N. Altankhuyag Becomes 27th Prime Minister of Mongolia," *The UB Post*, August 10, 2012, <<http://ubpost.mongolnews.mn/?p=345>>.

¹⁶⁶ Indeed, Prime Minister Wen Jiabao visited Mongolia as a side trip in June 2010 en route to another country. Mongolia was not the focal point of Wen's trip in Asia.

The trip was heralded as the strengthening of China-Mongolia relations. However, to astute watchers of the Chinese political system, it was a telling sign of Beijing's perspective on the Mongolian relationship: send the lowest ranking standing committee member, one that has no influence on foreign affairs or finance, only public security and the justice ministry.¹⁶⁷ To put matters into perspective, Zhou Yongkang is the official that the Chinese government dispatches mainly to Pyongyang for ceremonial matters. When Beijing truly wants to send a message to Pyongyang, Zhou Yongkang is not the envoy who they send to communicate matters of substance. Rather, it is usually the state councilor who manages the political portfolio for China. It was a clear message from Beijing that probably went unnoticed in Mongolia; until Mongolia decides where it will orient its politics and economics, China will not invest a lot of time nor government resources there.

The underlying message for Mongolia was to either continue to adhere to the old ways of Russian control of the Mongolian body politic or venture into the clearer choice, according to Beijing, of orientation towards China and the attendant economic and political benefits associated with closer ties. Since then, the standing committee position within the Politburo once held by Zhou Yongkang has been eliminated.

Mongolia has thus far been unable to develop a strategy to best serve its national interests. Its leaders continue to vacillate, Even worse, they behave in a manner that is not acceptable by any

¹⁶⁷ Zhou Yongkang served as State Councillor (one of nine in the Standing Committee of the State Council) and was the Central Political-Legal Committee chair, which is a Politburo Standing Committee position. However at the 18th Party Congress, this position was abolished and the Standing Committee's membership was reduced from nine to seven members. Zhou retired at the 18th Party Congress.

international norms for business, to wit, fail to renegotiate agreements or once finalized implement them. Recently, it has attempted to draw in Japanese, South Korean, and some U.S. support to build on its “Third Country strategy” in its foreign policy.¹⁶⁸ However, in the final analysis, Mongolia is wedged between Russia and China and clinging to the one country that no longer serves its long-term national interests, Russia.

In November 2012, the standing committee of the Chinese Politburo was reduced in membership from nine to seven seats.¹⁶⁹ Misreading the tea leaves, the Mongolians seem to have not deciphered the delicacy of the message Beijing was sending to Ulan Baator. Perhaps the Mongolians viewed the elimination of the seat once held by the standing committee member and senior official who directly visited Ulan Baator as a mere coincidence. Moreover, strengthening of China-Russia ties only diminishes the value of Mongolia from a geostrategic perspective of China. Only time will tell.

In September 2012, the new political leadership invited X to visit Ulan Baator once again. The working group on the railway and entire cabinet were seated as X answered questions on how to implement the railway project. A private meeting with the prime minister, Altankhuyag, further reinforced the impression to X that

¹⁶⁸ The term “third neighbor” was coined by then-Secretary of State James A. Baker in 1990 when he referred to the United States as Mongolia’s third neighbor in addition to geographical neighbors China and the Soviet Union. See, for example, Munkh-Ochir Dorjjugder, “Mongolia’s ‘Third Neighbor’ Doctrine and North Korea,” (The Brookings Institute, 2011), <http://www.brookings.edu/research/papers/2011/01/28-mongolia-dorjjugder>.

¹⁶⁹ The seven members of the 18th Central Politburo Standing Committee of the Communist Party of China (PSC) were elected in November 2012. For more information about these seven members, refer to “China’s New Leadership: Unveiled,” *The Diplomat*, November 16, 2012, <http://thediplomat.com/2012/11/16/chinas-new-leadership-unveiled>.

the Mongolians were truly serious this time about the implementation of the railway project under the signed JDA. Altankhuyag expressed his “support” for X’s continued participation in the railway project. In fact, the new minister of industry and agriculture, Battulga, would be the key decision-maker for the railway project.

To further reinforce the Mongolian message that this railway project leading from the TT mines to Liaoning Province, China, was moving ahead as planned and agreed upon, the speaker of parliament, Z. Enkhbold, hosted representative of X to a private dinner at the official government building. The speaker pledged his support to X’s participation and stated that the railway had to be operational by 2015 because Mongolia relies on tax revenue and royalties from the sale of natural resources to finance government operations.

The railway project also called for the use of wide gauge, or Russian gauge rail, rather than narrow or international gauge rails.¹⁷⁰ While not a point of contention between China and Mongolia for this railway project, it is a not-so-subtle reminder that Mongolia has chosen to be tethered to Russia.

The use of Russian gauge will only hamper Mongolia’s economic growth because it drastically diminishes the amount of throughput of commodities that can be transported on an annual basis from Mongolia to China and then to third countries. This is

¹⁷⁰ As a military tactic to hinder a possible invasion by railway, Russia developed broad gauge rail in the 19th century and this legacy of the former Soviet empire still remains in Mongolia. Russia’s wider gauge is 85 millimeters wider than the standard gauge used in China. See, for example, Michael Kohn, “Mongolia Rail Gauge Plan to Limit Cost Savings, Group Says (1),” *Bloomberg News*, May 10, 2013, <<http://www.businessweek.com/news/2013-05-10/mongolia-rail-gauge-plan-to-limit-cost-savings-group-says-1>>.

because the railcars have to stop at the border, be lifted by hydraulic cranes and then affixed again to railway cars that are on international gauge rails, which China and most of the world, including South Korea, North Korea, and the United States use for the railway networks. An uninterrupted shipment of commodities from Mongolia to its final destination in X would accelerate Mongolia's growth and also increase revenues and royalties for Mongolia's treasury.

The speaker of Mongolia's parliament supports the eastern railway. Minister Gansukh was present at all the meetings and suggested that the next step forward was a review of the railway licenses that were granted to MCS by the previous prime minister, some alleged illegally since it was granted on the eve of the end of Prime Minister Batbold's term without the proper review process. In reality, the undertone of this message was that Batbold was corrupt and sold the licenses to the highest bidder. It was not uncommon for him to do a "fire sale" at the expense of the country. It is widely known that Batbold benefitted from government "fire sales" since he purchased the landmark Chinggis Hotel located in the heart of downtown Ulan Baator from the government at a deep discount.

By November 2012, in one quick stroke of the pen, Mongolia's cabinet revoked the railway license of MCS to build a southern railway because it violated the railway policy as well as national security review. The Mongolia National Security Council is composed of three members: president, prime minister, and speaker of parliament. MCS was granted a license to build a railway on the eve of Batbold's departure from office in May 2012. The Ministry of Transportation informed X that Mongolia was ready to implement the project with X once the Transportation Ministry cal-

culated the compensation to be paid to MCS for the revocation of the license and reimburse MCS for funds that they had already spent building the railway.

By February 2013, in yet another complete surprise to X, the Mongolian government performed another reversal and announced a new tender for the building of the railway project. An observer would be incredulous at this point if not for the fact that for the past three years, the Mongolians have essentially drifted in opposing directions of the wind despite a binding agreement. It is as if an agreement executed by the government is merely a suggestion and not a commitment. It is no surprise that Chinese officials who work on Mongolia matters are resigned to this reality.

These actions demonstrate that such vacillation is a common theme running throughout Mongolia. From Rio Tinto's Oyu Tolgoi mine to the \$250 million agreement that was pre-paid by China Aluminum Corporation (Chalco) for the off-taking of coking coal to the foreign investment law that targeted Chinese and Russian state-owned firms—all speak to a wider credibility gap that exists within Mongolia.

X was caught blindsided, never consulted with, and indicated it would not send a proposal for consideration by the Mongolian government. Ganbat made the case that this tender was merely procedural and that X's original agreement remained in effect. He added, "Nothing has changed."

The Mongolian government is superb at weaving surprises into commercial activities. For example, in March 2013, the "finalists" to the railway tender were announced and included a new and unknown company by the name of "Ashmore Eurasia," which is apparently a shell company with alleged Russian support. How this company ever came to being and involved in the railway

project was a complete surprise to all stakeholders that have been involved since the conception of this project in 2010, including X.

These mixed and often uncertain signals are a signature trait of the Mongolian body politic. It is difficult to navigate business or political relations in Mongolia since it is a country that is not easily embarrassed in doing acts that should be considered contrary to social, economic, or political norms. In the end, perhaps Mongolia is uncertain about its place in the world and this insecurity has manifested itself in its policies.

Act Two: Mongolia's Cancellation of Its Coal Off-take Agreement with State-Owned Aluminum Corporation of China(CHALCO)

The act described above breeds further mistrust and deepens the anxieties that China has with its relations with Mongolia. Perhaps the only contiguous country that creates greater anxiety for China than Mongolia is North Korea.¹⁷¹

On Friday, July 29, 2011, under the direction of Prime Minister Batbold, Mongolia signed an off-take agreement with state-owned China Aluminum Corporation (Chalco). Under the terms of the agreement, Chalco would pay in advance \$250 million to Mongolian state-owned Erdenes Talvan Tolgoi at a pre-set price indexed to adjust for the quality of coking coal that is delivered.

¹⁷¹ It should be noted that Mongolia and North Korea enjoy extremely close ties. In fact, children of North Korean elite go to Mongolia for “summer camp” and Mongolian officials regularly travel to North Korea.

Ancillary to this agreement, South Korea's Korea Resources Corporation (KORES) and Japanese firms Itochu and Mitsui then purchased 30 percent of the allocation granted to Chalco.¹⁷²

With global coal prices starting to rise on signs of an economic recovery, by January 24, 2013, the newly elected government under the DP and headed by its new prime minister, Altankhuyag, attempted to renegotiate Mongolia's agreement with Chalco.¹⁷³ Mongolia argued that the pre-negotiated price was now too low in present market conditions.

However, in so arguing, Mongolia was certain to further deepen the mistrust by China towards it particularly when a May 2012 foreign investment law targeted China with discriminatory intent, as was widely acknowledged in Mongolia. According to Bloomberg, China imported 20.9 million metric tons of coal from Mongolia at a value of \$1.9 billion in 2012.¹⁷⁴

Not unlike the Rio Tinto Oyu Tolgoi copper and gold mine agreement, the Mongolian government sought to renegotiate the terms of an agreement that both parties signed. It was typical of the Mongolians to proceed in this manner, but nevertheless surprised even astute observers, since Chalco was a large state-owned Chinese company and, more importantly, Chalco was Erdenes TT's largest customer.

¹⁷² "Chinese, Mongolian companies sign \$250m coal deal," *China Daily*, July 29, 2011, <http://www.chinadaily.com.cn/bizchina/2011-07/29/content_13012041.htm>.

¹⁷³ Chuin-Wei Yap and Joanne Chiu, "Mongolia Coal Spat Heats Up," *The Wall Street Journal*, January 29, 2013, <<http://online.wsj.com/news/articles/SB30001424127887323644904578269511946929242>>.

¹⁷⁴ Michael Kohn, "Mongolia Loan May Help Tavan Tolgoi Exit Chalco Deal, CEO Says," *Bloomberg News*, January 24, 2013, <<http://www.bloomberg.com/news/2013-01-24/mongolia-loan-may-help-tavan-tolgoi-exit-chalco-deal-ceo-says.html>>.

With prices for the coking coal based upon an index, meaning that lower quality coal would be priced lower and higher quality coal would be higher, essentially Chalco bought a pre-paid \$250 million coking coal card that was no longer accepted in Mongolia. At prices above \$100 per metric ton, it was considered the market price. However, the Mongolian government now argued that these prices were below the cost of production. While Mongolia offered to refund Chalco its money, Chalco took an international stance on these matters and threatened to pursue legal action to enforce the contract.¹⁷⁵

The credibility gap of the Mongolia government has not deterred it from continuing its repeated behavior of renegotiating terms of an international agreement. Mongolia is in many ways behaving like North Korea. However, at some time in the future, China may make a determination that Mongolia is simply incorrigible. This would have the unfortunate effect of permanently leaving Mongolia a landlocked state with no access to the sea. Mongolia's unpredictability and proximity to Russia does not lend itself to an environment where it can transform itself into a financial hub that serves as the "Switzerland" of Central Asia. Instead, Mongolia, for the short and medium term must rely on selling its natural resources without any value added.

Act Three: Mongolia's 2012 Foreign Investment Law and China

¹⁷⁵ Wan Xu and David Stanway, "Chalco threatens legal action in Mongolia coal dispute," *Reuters*, January 29, 2013, <<http://www.reuters.com/article/2013/01/28/china-mongolia-chalco-idUSL4N0AX2AM20130128>>.

An attempt to ban China's state-owned companies from investment in Mongolia backfired and caused many foreign investors to exit Mongolia. Its currency, the Tugrik, depreciated between 20-60 percent unofficially and a mini-financial crisis occurred.

On Thursday, May 17, 2012, Mongolia's parliament passed an unfortunate law designed to ban Chinese state-owned companies from controlling a majority interest in its natural resource companies. Entitled the "Law of Mongolia on the Regulation of Foreign Investment in Business Entities Operating in Sectors of Strategic Importance," it was a misguided attempt by Mongolia's leaders to block investments in its country's natural resource sector by China's state-owned companies.

The catalyst for this law was a response to an attempt by SouthGobi Resources, a Mongolian mining company based in Canada, to sell a 58 percent stake to Chalco.¹⁷⁶ The law specifically stated that in the "strategic" sectors of mining, telecommunications, finance, and media, foreigners could not own more than 49 percent equity. In reality, this law was specifically designed for the mining sector, the only sector of interest for foreign investors in Mongolia. As a way to intimidate SouthGobi's move to sell its stake, local Mongolian authorities sealed the offices of SouthGobi Sands in a probe over corruption.¹⁷⁷

The language of the law was drafted vaguely, with the enabling regulations never promulgated; the law had the unintended

¹⁷⁶ Michelle Yun, "Chalco Agrees to Buy SouthGobi Stake to Gain Coal Mines," *Bloomberg News*, April 2, 2012, <<http://www.bloomberg.com/news/2012-04-02/chalco-agrees-to-buy-ivanhoe-southgobi-stake-for-c-889-million.html>>.

¹⁷⁷ "Mongolia Passes Watered Down Investment Law," *Reuters*, May 18, 2012, <<http://uk.reuters.com/article/2012/05/18/mongolia-mining-idUKL4E8GI3HV20120518>>.

consequence of frightening all foreign investors. It was a law that was passed in the parliament overwhelmingly by the newly elected members of the DP, now the ruling party in Mongolia. The law lingered and despite strong protests from foreign investors, Mongolia stood its ground, unwilling or unable to clarify its investment-defeating law. As a result, the Mongolian Tugrik depreciated unofficially by 20 to 60 percent during this period and about 3.7 percent officially against the U.S. dollar. To this day, the Mongolian currency has not fully recovered since this law was passed.¹⁷⁸

Conclusion

China's perspective of its relations with Mongolia is one of distrust, resignation, and consternation. Three recent events helped to further inform the Chinese body politic: Mongolia's evanescent national railway policy in 2010, Chalco's \$250 million off-take agreement for coal in 2011, and Mongolia's Foreign Investment Law of 2012 that sought to ban Chinese state-owned enterprises from owning majority shares of natural resource companies in Mongolia.

In all three cases, the Mongolian political leadership in both the Mongolia People's Party (MPP) followed by the latest ruling party, the Democratic Party (DP), has demonstrated its inability to honor its commitments and abide by the rule of international law. This is not to say that commercial agreements can never be

¹⁷⁸ At the time of this writing, the Mongolian parliament is considering a review of the foreign investment law and a repeal.

renegotiated. Occasionally, renegotiations are imperative. However, what China's experience in Mongolia (and even British experiences such as Rio Tinto) has highlighted in recent years is that renegotiations and the unraveling of commitments by the Mongolian government are more a deliberate pattern of incompetency, selfishness, and parochialism rather than being outlier events. The China experience in Mongolia is a cautionary tale about doing business in Mongolia, not just for Chinese state-owned companies. Instead, it is clarion call to all foreign investors in general: caveat emptor.

Mongolia is at a tipping point in its relations to the world. As the railway project demonstrated, does it wish to situate itself alongside Russia or orient itself towards China, the United States, and South Korea? It is a difficult decision for Mongolia because it is completely dependent upon Russia for its energy needs. Additionally, Mongolia's fear of sinicization is so deeply ingrained that it has become a psychological barrier affecting its financial policies and economic development.¹⁷⁹

By perpetuating the status quo and not making difficult decisions, Mongolia will, sadly, continue to idle in its current quagmire. China's approach in its relations to Mongolia may be less accommodating in the future as a result of the events that it considers specifically targeted towards itself. In truth, Mongolia had no qualms about denying the intent of these laws or renegotiating its agree-

¹⁷⁹ Justin Li at the Institute of Chinese Economics (ICE) mentions, "The imperial legacy of China still lingers in the minds of some Mongolians and this landlocked country only gained independence from China as late as 1921;" Justin Li, "Chinese investment in Mongolia: An uneasy courtship between Goliath and David," (East Asia Forum, February 2, 2011), <<http://www.eastasiaforum.org/2011/02/02/chinese-investment-in-mongolia-an-uneasy-courtship-between-goliath-and-david/>>.

ments—Mongolia simply felt it could get away with it without any major consequence. These events, from Beijing's perspective, had the unfortunate effect of highlighting the risks in strengthening relations with Mongolia. In the meantime, Mongolia's window to the world may be closing.